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UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

SAN FRANCISCO DIVISION **E-Filing**

DAVID KAYNE, an individual citizen of Georgia, Plaintiff, vs. THE THOMAS KINKADE COMPANY, formerly known as MEDIA ARTS GROUP, INC., a Delaware Corporation, Defendant.	Case No. C 07-4721 SI Related Case: C 04-00186 SI **PLAINTIFF'S MEMORANDUM IN OPPOSITION TO DEFENDANT'S MOTION TO DISMISS (Fed.R.Civ.P. 12(b)(6))** Hearing Date: December 7, 2007 Hearing Time: 9:00 a.m. Before: Hon. Susan Illston

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I. INTRODUCTION AND SUMMARY OF ARGUMENT IN OPPOSITION TO TKC'S MOTION TO DISMISS

Plaintiff David Kayne ("Plaintiff" or "Mr. Kayne") respectfully submits this memorandum in opposition to the motion of defendant, The Thomas Kinkade Company ("TKC"), to dismiss his complaint. This memorandum is supported by the accompanying Declarations of Charles L. Coleman ("Coleman Dec.") and Gary L. Britt ("Britt Dec."), and exhibits thereto, in opposition to TKC's motion to dismiss. Pursuant to Federal Rule of Evidence 201, Plaintiff requests judicial notice of the court documents attached to the Coleman Dec. and the Britt Dec.

A. Procedural Background

1. Mr. Kayne's Original Complaint and First Amended Complaint

Plaintiff's original complaint was filed on September 13, 2007, and assigned to Judge Fogel (Document 1). The original complaint sought declaratory and injunctive relief to prevent TKC from proceeding with an "expedited" (no witness) arbitration hearing set to occur on October 16, 2007 or, in the alternative, from enforcing any award resulting from such a procedure.

Mr. Kayne's First Amended Complaint ("FAC") is substantially similar to his original complaint, the main differences being that: (a) The FAC (filed after the October 16 arbitration went forward)[1] does not seek to enjoin TKC's participation in

[1] On October 2, 2007, Plaintiff filed motion papers before Judge Fogel seeking a temporary restraining order and injunctive relief to prevent TKC from proceeding with the October 16 hearing. (Documents 5-13). TKC filed its opposition papers on October 3, 2007 (Documents 16-23), and on October 4, Mr. Kayne filed reply papers in support of his request for a temporary restraining order and injunctive relief (Documents 34-35), after which the matter was deemed submitted without hearing. No ruling was made by the Court before the October 16 hearing, so the parties stipulated on October 26 that the request to enjoin the October 16 hearing was moot. (Document 39). The parties also stipulated that the FAC could be filed in lieu of the original complaint, so that the issues could be re-focused on Mr. Kayne's alternative request for relief from any award resulting from the October 16 hearing.

the now-concluded "no witnesses" arbitration proceeding but instead seeks only to prevent enforcement of the Award resulting from that proceeding; and (b) The FAC changes, corrects and updates certain factual averments but does not render moot the issues raised in TKC's motion to dismiss or its separate motion to strike.[2]

2. TKC's Motions Apply to the First Amended Complaint.

In order to obtain a prompt ruling on TKC's motions (and on Mr. Kayne's oppositions to those motions), the parties stipulated (and the Court on October 29 ordered) that TKC's motions filed on October 4 would be deemed to apply to Plaintiff's First Amended Complaint, which was filed on November 2, 2007. (Documents 40, 42, 43). Accordingly, all further references in this opposition will be to the First Amended Complaint and not to the original complaint, which has been superseded.

B. Summary of Argument in Opposition to Motion To Dismiss.

Mr. Kayne's complaint (the FAC) is based on the Ninth Circuit's recent decision in *Nagrampa v. Mailcoups, Inc.*, 469 F.3d 1257 (9th Cir. 2006) (*en banc*) ("*Nagrampa*") finding (contrary to the earlier Ninth Circuit panel decision reported at 401 F.3d 1024 (9th Cir. 2005) ("*Nagrampa I*")) that: (1) An arbitration clause in a contract of adhesion that imposes unequal or unfair burdens on the weaker party is unconscionable and unenforceable under California law; and (2) The issue of unconscionability of the arbitration clause will be decided by a court rather than the arbitrator, even where the procedural unconscionability of the contract applies to the entire agreement. The issues presented in the FAC have not been presented to, considered by, or ruled on by any other court, and it is ludicrous to assert (as TKC does) that Mr. Kayne "could have" challenged the unconscionability of the

[2] Documents 24-33. Plaintiff is filing, concurrently with this opposition, a separate memorandum of points and authorities in opposition to TKC's motion to strike.

arbitration procedure incorporated in TKC's Personal Guaranty in other proceedings before *Nagrampa* had even been decided.

Nevertheless, TKC's central contention (at pages 9-14 of its motion) is that proceedings in Georgia before Judge Pannell (involving the separate questions of whether the Personal Guaranty incorporated the arbitration procedure, had been accepted by TKC, or was supported by consideration) somehow also reached an issue never presented to him – the unconscionability of the arbitration clause under the standard articulated by the Ninth Circuit in *Nagrampa*.[3] Prior to *Nagrampa*, Mr. Kayne was obliged to present his unconscionability argument to the arbitrator in the California arbitration proceedings found to be incorporated in TKC's Personal Guaranty; after *Nagrampa,* the ground was shifted and the unconscionability argument became one to be presented to a court.

Understandably, TKC is desperate to forestall any judicial scrutiny of the draconian "no witnesses" arbitration rules it embedded in its "Personal Guaranty" agreements, so it is arguing that Judge Pannell's decision was somehow *res judicata* with respect to this issue. If TKC's argument were correct (and it is not), then Mr. Kayne will have been deprived of his right to challenge TKC's clearly unconscionable arbitration clause in any forum. As will be shown below, the applicable case law simply does not support such a contention.

Throughout its pleadings, TKC argues, in effect, that Mr. Kayne should not complain about having been denied basic due process rights in the no-witness

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[3] TKC's arbitration clause is invalid under *Nagrampa* because it is part of a contract of adhesion that is procedurally unconscionable in view of TKC's superior bargaining power and resources, as well as the manner in which it was presented as part of a deceptive marketing campaign. The arbitration clause is substantively unconscionable because the inability to call witnesses, and the requirement to defend an arbitration in California (thousands of miles from Mr. Kayne's home), are burdens that fall disproportionately on Mr. Kayne. Because TKC's claim is based only on TKC's paper invoices while Mr. Kayne's defenses are based on surrounding factual circumstances that can only be developed through the examination of witnesses, it is no accident that TKC's "no witness" procedure unfairly favors TKC.

California arbitration "hearing" because (in TKC's view) Mr. Kayne does not really have very good arguments anyway. This argument is fundamentally misconceived: The narrow question before this Court is whether the arbitration procedure in TKC's agreement is unconscionable under *Nagrampa*; it is not whether or to what extent Mr. Kayne will ultimately prevail in his arguments against TKC's "Personal Guaranty" once he is afforded a proper hearing.

In addition to being both misconceived and premature, TKC's assertion that Mr. Kayne does not have (or is collaterally estopped from asserting) arguments against TKC's collection effort under the Personal Guaranty is simply wrong. TKC continues to assert, despite rulings from this Court and the Ninth Circuit to the contrary, that Mr. Kayne was personally bound by the arbitration between TKC and Kayne Art Galleries of Georgia, Inc. ("KAG") with respect to the Personal Guaranty, even though that arbitration pertained only to the Dealer Agreements between TKC and KAG and not to the Personal Guaranty.

TKC's arguments concerning the legal adequacy of Mr. Kayne's claims under the California Unfair Competition Law, Cal. Bus. & Prof. Code sections 17200, *et seq.* (the "UCL") also are without merit, for the reasons clearly articulated by Judge Jenkins in denying (after remand from the Ninth Circuit's *Nagrampa* decision) the defendants' very similar Rule 12(b)(6) motion to dismiss plaintiff Nagrampa's UCL claim. *Nagrampa v. Mailcoups, Inc.*, 2007 WL 2221028 at p. *3 (N.D. Cal., July 30, 2007) (finding that a claim of unconscionability meets the "unfair" prong of the UCL) .

TKC's arguments to the effect that Mr. Kayne has not stated a claim based on the unconscionability of TKC's arbitration procedure are similarly without merit. Mr. Kayne's claim is patterned on the claim upheld in *Nagrampa*. TKC's efforts to distinguish its clause or otherwise side-step the facial unconscionability of

an arbitration provision that would subject the weaker party to a "no witness" hearing far from his home state on a claim of over $1 million must fail.

Finally, it is clear that TKC will seek to enforce the "Final Award" that has recently resulted from the October 16 proceedings under its "no witnesses" arbitration clause, so the issues of unconscionability and procedural due process presented by the FAC will also be presented in any proceeding to enter a judgment based on the award. For this reason, TKC's exertions in seeking a dismissal of the claims in the FAC (which are in essence *defenses* against the enforcement of TKC's "Final Award") are pointless.

II. COUNTER-STATEMENT OF THE FACTS

A. The "Final Award" Served on November 15, 2007

The facts relevant to this matter are set out in the FAC, and it is axiomatic that the allegations of the FAC must be taken to be true for the purposes of ruling on TKC's motion to dismiss under Rule 12(b)(6). Ironically, TKC has submitted a large volume of background pleadings in support of its purported Rule 12(b)(6) motion (*see* Documents 26-32) at the same time that TKC is seeking (in a separate motion) to strike certain basic background information from the FAC.

The only significant factual development since the November 2 filing of the FAC is the "Final Award" resulting from the October 16 "no witnesses" arbitration, which was served on the afternoon of November 15, 2007. A copy of this "Final Award" is attached as Exhibit 1 to the Coleman Dec.

The "Final Award" is a five-page document that recites that it came on for a "prove-up hearing" that was not attended by Mr. Kayne. The "Final Award", predictably, gives TKC everything that it requested (including its legal fees for preparing the motions presently pending before this Court), other than a declaration of TKC's right to receive prospective attorneys' fees for its further activities in proceedings before this Court. Thus, the "Final Award" has already

purported to decide that TKC has prevailed in its motions before this Court since TKC has been awarded its fees for preparing these motions.[4] The total amount awarded to TKC (based on an initial alleged debt of $554,605 as of 2004, but adding interest and various costs including attorneys' fees) is "$1,230,141.88". The Final Award does not purport to address the fairness or unconscionability of an arbitration procedure in which a $1.2 million was required to be adjudicated without a right to call and cross-examine witnesses, nor does it purport to address any of Mr. Kayne's defenses including those based on misrepresentations made to him by or on behalf of TKC that induced him to sign the Personal Guaranty.

Inevitably, TKC will shortly seek to obtain the imprimatur of this Court on the "Final Award" that it has now procured through the use of its "expedited" (no witnesses) arbitration procedure, in which Mr. Kayne refused to participate both because of the futility of such a procedure and to avoid waiving the unconscionability objections which, under *Nagrampa*, he presents to this Court.

B. TKC's Mischaracterizations of Mr. Kayne's Positions in Prior Proceedings.

In its motion, TKC seeks to portray Mr. Kayne as having "flip-flopped" on various issues. This effort depends on mischaracterizing Mr. Kayne's positions.

For example, at pages 10-11 of its motion, TKC asserts that Mr. Kayne has taken inconsistent positions on the applicability of California law to the Personal Guaranty. Specifically, TKC asserts that since Mr. Kayne argued in the Georgia proceedings that Georgia law should apply to the contractual issues surrounding the *formation* of the contract, while he is now arguing that California law should apply in determining whether an arbitration clause calling for a "no witness"

[4] *See* Coleman Dec., Exhibit 2 (copy of the Declaration of TKC's counsel Dana Levitt submitted to the arbitrator, describing at paragraph 6 the exertions of TKC's counsel in preparing the motions before this Court, for which TKC has sought and already obtained a "Final Award" from the arbitrator).

arbitration to be conducted within the State of California is unconscionable under the public policy of California as articulated in Cal. Civil Code section 1670.5 (unconscionability), the California Unfair Competition Law (Cal. Bus. & Prof. Code §§ 17200, *et seq.*) and *Nagrampa*. This argument overlooks a number of factors, such as the different choice of law rules applicable in Georgia and California,[5] and the doctrine of depecage under which different laws can appropriately be applied to different aspects of a dispute.[6] Moreover, it is pointless because TKC agrees that California law applies here. (TKC motion at 11, footnote 3).

Similarly, at page 11 of its motion, TKC seeks to obfuscate the point (made at ¶ 6 of the FAC) that while the AAA "expedited rules" *do* provide for disputes to be resolved "by the submission of documents" where there is less than $10,000 at stake, they allow for exceptions not allowed under TKC's arbitration clause, and they do not contemplate that million-dollar claims should be decided under the "expedited rules". Further, at page 11, TKC mischaracterizes paragraph 16 of the FAC by suggesting that Mr. Kayne asserts that "the Dealer Agreements provide him as an individual with protections under the Franchise laws". Instead, Mr. Kayne asserts that he was personally misled by TKC's failure to comply with the franchise laws when TKC promoted the "Application for Credit" and "Personal Guaranty" in conjunction with the Dealer Agreements, and that this gave rise to both procedural unconscionability under *Nagrampa* and a violation of the UCL as an "unfair" business practice under California law. The bottom line is that TKC is

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[5] Unlike California (which uses an "interests" analysis under the Second Restatement of Conflict of Laws), Georgia continues to adhere to the "lex loci" choice of law rules articulated in the First Restatement. *See Dowis v. Mud Slingers, Inc.*, 279 Ga. 808 (Ga. Supreme Court, 2005).

[6] TKC's quarrel with Mr. Kayne's contention that Georgia law applied to certain aspects of the Personal Guaranty raises issues of depecage that are beyond the scope of this case. *See generally,* Willis L.M. Reese, *Depecage: A Common Phenomenon in Choice of Law*, 73 Columbia L. Rev. 58 (1973).

seeking to divert attention from the merits of Mr. Kayne's claims in this case by asserting (incorrectly) that he has taken inconsistent positions in the past.

III. THIS ACTION IS NOT BARRED BY *RES JUDICATA.*

A. *Res Judicata* Attaches Only to Claims Available at the Time of Filing the Original Complaint.

It is well established in this circuit that "[r]es judicata attaches only to claims available at the time of filing the original complaint". *FMC Corp. v. Up-Right, Inc.*, 816 F. Supp. 1445, 1461 (N. D. Cal. 1993). In other words, the scope of litigation is framed by the complaint at the time it is filed. *Id.* The rule that a judgment is conclusive as to every matter that might have been litigated "does not apply to new rights acquired pending the action which might have been, but which were not, required to be litigated." *Id.* (citing *Los Angeles Branch NAACP v. L.A. Unified School District*, 750 F.2d 731, 739 (9th Cir. 1984) (*en banc*)).

Plaintiffs may bring events occurring after the filing of the complaint into the scope of the litigation by filing a supplemental complaint with leave of court, but there is no requirement that plaintiffs do so. *Id.* As stated in *Los Angeles Branch NAACP*, "[w]e decline to impose a potentially unworkable requirement that every claim arising prior to the entry of a final decree must be brought into the pending litigation or lost." 750 F.2d at 739, n. 9.

Mr. Kayne filed his original Complaint in Georgia state court. His complaint was thereafter removed to the Northern District of Georgia on September 12, 2006. Britt Dec., ¶ 1 (N.D. Ga. Civil Docket). As TKC concedes, the Ninth Circuit's *en banc* decision in *Nagrampa* was not filed until December 4, 2006. TKC Motion to Dismiss, p. 14. Under *FMC Corp.*, *supra*, the original complaint controls for purposes of determining "claims which might have been, but which were not, required to be litigated." *FMC Corp.*, 816 F. Supp. at 1462.

Whether or not Mr. Kayne had "ample opportunity" to raise an entirely new claim or argument based on judicially-reviewable unconscionability of the arbitration provisions at any time after September 12, 2006 is irrelevant. Under *FMC Corp.*, Mr. Kayne was only obligated to bring *available* new claims by September 12, 2006, at the very latest. As set forth in detail below, a claim for judicial rejection of TKC's arbitration clause based on its unconscionability was not available to Mr. Kayne until after the *Nagrampa* decision was handed down on December 4, 2006.

In addition to not being required to amend his Georgia complaint after December 4, 2006 to add a new claim based on *Nagrampa*, Mr. Kayne was, as a practical matter, not in a position to do so. The parties had already submitted their motion papers to Judge Pannell based on the existing pleadings, and Mr. Kayne's Second Amended Complaint filed in late October, 2007 was allowed to be filed only based on the express understanding that it would not add any new claims or issues. This is evident from Judge Pannell's Order (Document 29 in the Georgia district court proceedings, a copy of which is attached as Exhibit 11, pages 153-54 to TKC's Request for Judicial Notice), where it is stated that:

> *After much consideration*, the court will allow Kayne leave to amend his complaint. Kayne has *not unduly delayed* filing his motion to amend and there is *no prejudice* to TKC. The arguments Kayne seeks to clarify in his amended complaint are the *same arguments* Kayne has presented in opposition to TKC's motion to compel arbitration. [Italics added.]

The clear indication from the foregoing language is that the district court in Georgia would have taken a dim view of (and very likely denied) any attempt, after the motions had been briefed, to add an entirely new and different claim raising new arguments based on *Nagrampa*. In any event, a claim under *Nagrampa* was clearly not available to Mr. Kayne until the decision was filed on December 4, 2006, nearly three months after the most generous cut-off date for *res judicata* purposes.

The U.S. Supreme Court has stated that: "Because res judicata may govern grounds and defenses not previously litigated, however, it blockades unexplored paths that may lead to truth. For the sake of repose, res judicata shields the fraud and the cheat as well as the honest person. It therefore is to be invoked only after careful inquiry." *Brown v. Felsen*, 442 U.S. 127, 132 (1979). As noted by the Ninth Circuit in *Clark v. Bear Stearns & Co.*, 966 F.2d 1318, 1321 (9th Cir. 1992):

> The party asserting preclusion bears the burden of showing with clarity and certainty what was determined by the prior judgment. *United States v. Lasky*, 600 F.2d 765, 769 (9th Cir.), *cert. denied*, 444 U.S. 979 . . . (1979). "It is not enough that the party introduce the decision of the prior court; rather, the party must introduce a sufficient record of the prior proceeding to enable the trial court to pinpoint the exact issues previously litigated." *Id.*
>
> . . . .
>
> By definition, res judicata bars only those grounds for recovery which could have been asserted in the prior litigation. . . . If a claim could not have been asserted in prior litigation, no interests are served by precluding that claim in later litigation.

TKC's response to Mr. Kayne's challenge to its unconscionable "expedited" arbitration procedure is long on explanations as to why Mr. Kayne should now be precluded from making this argument and very short on explanations of why TKC's effort to apply its "no witness" procedure is not unconscionable. TKC seeks to side-step the truth by pretending that the issue of unconscionability was or "should have been" raised before Judge Pannell, even though the argument did not exist until the Ninth Circuit's decision in *Nagrampa*.

B. Under the Ninth Circuit's Four-Part Test, the Matters Raised in the Present Action Are Not the Same as Those Presented to Judge Pannell.

It is well-established that "[b]ecause res judicata is a defense, [the courts] view all facts in the light most favorable to the plaintiff." *Chao v. A-One Medical*

Services, Inc., 346 F.3d 908, 921 (9th Cir. 2003). This necessarily affects the view of the facts to be taken in this matter.

One of the few areas of agreement between Mr. Kayne and TKC is that the Ninth Circuit has recognized a four-part test in determining whether successive actions involve the same cause of action: "(1) whether the rights or interests established in the prior judgment would be destroyed or impaired by prosecution of the second action; (2) whether substantially the same evidence is presented in the two actions; (3) whether the two suits involve infringement of the same right; and (4) whether the two suits arise out of the same transactional nucleus of facts." *In re International Neutronics, Inc.*, 28 F.3d 965, 969 (9th Cir. 1994), *citing Clark v. Bear Stearns & Co., supra,* 966 F.2d at 1320. These factors must be examined subject to the *caveat* that, by definition, res judicata "bars only those grounds for recovery which could have been asserted in the prior litigation"; here, such grounds could not have been asserted because they did not exist.

1. The Limited Rights and Interests Established in the Georgia Litigation Will Not Be Impaired by Examining the Unconscionability of the "Expedited" Arbitration Clause.

At issue in the Georgia litigation was the question whether the "Personal Guaranty" accompanying the "Application for Credit" were the following issues: (1) Whether the "Personal Guaranty" was supported by consideration; (2) Whether the "Personal Guaranty" had been accepted by TKC; and (3) Whether the reference in the "Personal Guaranty" to "the above arbitration clause" (in the "Application for Credit") constituted an agreement by Mr. Kayne to arbitrate issues of his personal liability under the Guaranty. Mr. Kayne acknowledges that Judge Pannell ruled against him on these issues and that the Eleventh Circuit has affirmed those rulings. As the Eleventh Circuit's decision confirms, however, the issues presented

in the Georgia litigation involved only the foregoing issues as to whether an agreement was formed between Mr. Kayne and TKC, and not the entirely separate question – presented for the first time by the Ninth Circuit's decision in *Nagrampa* well after the Georgia case had been submitted to Judge Pannell – as to whether such an agreement, if formed, is *unconscionable*.

The Georgia litigation established that TKC had a contract with Mr. Kayne, in the form of a "Personal Guaranty", calling for arbitration of disputes arising under the "Personal Guaranty". This finding, as such, would not be affected by the limited relief that Mr. Kayne seeks here, which is a determination that the arbitration clause in the agreement is unconscionable.

More importantly, Judge Pannell expressly limited his rulings to the issues presented to him, and directed that:

> "*Because all of the issues remaining in the case at hand are referable to arbitration and the arbitration will take place in California,* it would serve no purpose for the court to retain jurisdiction and stay the action pending arbitration. . . . The court, therefore, GRANTS the defendant's motion to compel arbitration (Doc. No. 14) *to the extent it seeks dismissal of the action and an order compelling arbitration.*" [7] [Italics added.]

Clearly, Judge Pannell did not rule on the issue of unconscionability of the arbitration clause or procedure but to the contrary expressly contemplated – consistent with the law before *Nagrampa* – that any such issues would be "referable to arbitration . . . in California". Because *Nagrampa* is now the law of this Circuit, however, it is no longer appropriate to present the issue of unconscionability of the arbitration clause to the arbitrator, and is instead appropriate to present the issue to this Court. TKC's "res judicata" argument is merely a smoke screen intended to divert this Court from applying the law of this circuit to TKC's California arbitration and arbitral award.

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[7] Order in N.D. Ga. No. 1:06-CV-2168-CAP (Document 29), at p. 28, a copy of which is attached to TKC's Request for Judicial Notice as Exhibit 11, at Exhibit pages 175-176.

2. Different Evidence Is at Issue Here

In the Georgia action, the evidence necessarily focused on whether TKC had given consideration in exchange for the Personal Guaranty signed by Mr. Kayne, and in particular whether it had extended credit to Mr. Kayne personally as a suitable form of acceptance. *See* the Eleventh Circuit's decision (Exhibit 17 to TKC's Request for Judicial Notice). Also at issue in the Georgia proceedings was whether the arbitration clause applied, by its terms, to Mr. Kayne personally. None of those issues is present in the instant action, which involves entirely separate issues that *assume* the existence of an agreement between Mr. Kayne and TKC to arbitrate, but present distinct issues not addressed in the Georgia decision, such as: (1) The procedural unconscionability that attended Mr. Kayne's entering into the agreement for "expedited" arbitration; and (2) The substantive unconscionability of the "expedited" arbitration procedures as TKC seeks to apply them here. In short, it is axiomatic that the evidence relevant to contract formation (consideration, acceptance by TKC's action, *etc.*) are not "substantially the same" as the evidence of substantive and procedural unconscionability presented here.

3. The Two Actions Do Not Involve "Infringement of the Same Right".

As noted, these matters involve defenses being raised by Mr. Kayne to an arbitration that had yet to occur. In the Georgia proceedings, Mr. Kayne sought to vindicate his right not to be subject to an arbitration clause when he did not, so he asserted, actually have a binding agreement to arbitrate. *See First Options of Chicago v. Kaplan*, 514 U.S. 938, 943-44 (1995) and *Ralph Andrews Production, Inc. v. Writers Guild*, 938 F.2d 128 (9th Cir. 1991). Here, the right (or defense) that Mr. Kayne seeks to vindicate is the one recognized for the first time in *Nagrampa* — to be free from an arbitration clause that is unconscionable under California law. As

noted above, Judge Pannell did not rule on that issue but instead contemplated that it would have to be addressed in the California arbitration proceedings. Because *Nagrampa* was decided before those proceedings commenced, it is appropriate to apply (rather than to ignore) *Nagrampa* in determining the unconscionability issue.

4. The Georgia Action Did Not Arise Out of the Same "Nucleus of Facts".

While it is undeniable that the Georgia action involved the same agreements (the "Personal Guaranty" and "Application for Credit") implicated here, the relevant facts in determining unconscionability are different. The issue of unconscionability simply was not presented to Judge Pannell in the Georgia proceedings, and for a very good reason—the issue in Mr. Kayne's case was not subject to judicial determination until *Nagrampa* was decided by the Ninth Circuit.

C. *Res Judicata* Does Not Apply Where a Change in the Law Creates a "New" or "Altered" Situation Not Addressed by the First Judgment.

It has been broadly held that "res judicata is no defense where between the time of the first judgment and the second there has been an intervening decision or a change in the law creating an altered situation." *State Farm Mut. Automobile Ins. Co. v. Duel*, 324 U.S. 154, 162 (1945); *see also, Blair v. Commissioner of Internal Revenue*, 300 U.S. 5, 8-9 (1937) (holding that initial Seventh Circuit decision finding certain assignments invalid under state law was not *res judicata* where a "new situation" was created by an intervening state court decision contrary to the Seventh Circuit's that declared the assignments valid).

The Ninth Circuit adopted this "altered" or "new" situation analysis in *West Coast Life Ins. Co. v. Merced Irr. Dist.*, 114 F.2d 654, 662 (9th Cir. 1940). In *West Coast Life*, an initial proceeding resulted in a judgment of dismissal for lack of jurisdiction based on a statute deemed unconstitutional. *Id.* at 658. However,

subsequently, a new statute was enacted, which was declared valid by the Supreme Court, that gave the District Court jurisdiction to hear such matters. *Id.* at 660. The Ninth Circuit held: "[t]his [prior] holding cannot be tortured into a decree that forever bars the petitioner from enjoying with all others this completely changed situation." *Id.* at 660. The Ninth Circuit ultimately concluded that the enactment of a new and different statute and a decision by the Supreme Court declaring the statute constitutional, created a "new situation" sufficient to justify the denial of the res judicata plea. *Id.* at 662 (citing *Blair v. Commissioner, supra*).

It also is well-settled that "res judicata cannot extinguish claims that did not even exist and which could not possibly have been sued upon in the previous case." *Intermedics, Inc. v. Ventritex,* 775 F. Supp. 1258, 1263 (N.D. Cal. 1991). TKC's *res judicata* argument fails because the *Nagrampa* decision created a new and/or altered situation for Mr. Kayne. Therefore, he could not have reasonably asserted his unconscionability claim during the Georgia action. Only after the *Nagrampa* decision, which overturned the Ninth Circuit's March 21, 2005 *Nagrampa I* ruling in effect during the Georgia action, could Mr. Kayne have been on notice that such a claim of unconscionability was not only possible to bring, but was indeed now the only proper means of challenging an unconscionable arbitration proceeding about to unfold within the State of California. A decision that the current action is barred by *res judicata,* however, would render Mr. Kayne forever precluded "from enjoying with all others this completely changed situation." *West Coast Life, supra,* 114 F.2d at 660. In fact, Mr. Kayne would be uniquely and unfairly deprived of the opportunity to raise the unconscionability issue in *any* forum.

D. *Nagrampa* Altered Unconscionability Analysis Applicable to Arbitration Clauses in Contracts of Adhesion.

The Ninth Circuit in *Nagrampa* utilized California's traditional "sliding scale" unconscionability test, including an analysis of both procedural and

substantive unconscionability. *Nagrampa* , 469 F.3d at 1280-82; *Armendariz v. Foundation Health Services, Inc.* 24 Cal. 4th 83, 114 (2000). The decision altered the landscape, however, by rendering it virtually impossible for a franchisor (or a large company operating a franchise-like system involving small businesses in distant locations) to defend against a procedural unconscionability challenge. By establishing the existence of a relationship where one large corporate party (the drafter of a contract of adhesion) has superior bargaining power and presented the contract on a take-it-or-leave-it basis, the disadvantaged party (Mr. Kayne, in this case) can tip the scale so that a court will consider substantive unconscionability of the arbitration clause – which exists in abundance in this case. This simply was not the law before *Nagrampa* and its progeny.

The court found that Nagrampa was in a substantially weaker bargaining position than MailCoups because MailCoups' parent company was a large corporation with $208,553,000 in assets and $1,016,492,000 in revenues. Nagrampa, on the other hand, had a yearly salary of $100,000 and never owned her own business. Furthermore, MailCoups drafted the contract and presented the contract on a take-it-or-leave it basis. *Id.* at 1282-84. Those same factors apply to Mr. Kayne's dealings with TKC.

Even a cursory review of the *Nagrampa* opinion reveals the far reaching implications of such a holding—the decision all but removed this first procedural unconscionability hurdle for a franchisee challenging an arbitration provision in a standard form contract. Moreover, the Ninth Circuit has not limited this new procedural unconscionability analysis to arbitration provisions found in franchise agreements, but has also begun to apply this analysis to other agreements and relationships as well. For example, the Ninth Circuit recently applied the analysis to an employer-employee arbitration agreement. In *Davis v. O'Melveney & Meyers*,

485 F.3d 1066, 1075 the Ninth Circuit made a finding of procedural unconscionability after stating:

> "In contrast, where—as is the case with Davis as a paralegal in an international law firm—the employee is facing an employer with 'overwhelming bargaining power' that 'drafted the contract, and presented it to [Davis] on a take-it-or-leave-it basis,' the clause is procedurally unconscionable." (citing *Nagrampa* , 469 F.3d at 1284).

Accordingly, it is the overall factual framework of unequal bargaining power coupled with disadvantageous arbitration terms that render arbitration clauses unenforceable under *Nagrampa* and *Davis*. As demonstrated by *Davis*, the reasoning of *Nagrampa* is not limited to franchise agreements. Mr. Kayne's challenge to TKC's arbitration clause therefore does not depend upon whether TKC violated the California or federal franchise laws. The overall nature of the relationship between TKC and Mr. Kayne was sufficient to trigger judicial scrutiny of the procedural and substantive unconscionability of TKC's "expedited" arbitration procedures.

E. *Nagrampa* Expanded the Role of Courts in Determining Whether an Arbitration Clause Is Unconscionable.

The Supreme Court's decision in *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006) ("*Buckeye*") decision was initially viewed as setting a "strong presumption that arbitrators will be deciding many of the issues regarding the enforceability of contracts." As a result, the 9th Circuit's *Nagrampa* ruling was "striking to many people."[8] Indeed, a simple Google search of "Nagrampa" reveals that this is an understatement. *See* Coleman Dec. at Exhibit 4 (DLA Piper online article dated January 2007 stating at p. 1 that the *Nagrampa* decision "has caused substantial concern among franchisors that include arbitration clauses in their

[8] The National Law Journal, Vol. 29, No. 35, *Franchisors May Have tougher Time Arbitrating*, May 7, 2007 (citing Eric Tuchmann, general counsel and corporate secretary for the American Arbitration Association). A copy of this article is attached as Exhibit 3 to the Coleman Dec.

franchise agreements", and at p. 6 that *Nagrampa* "may have a tremendous impact on many standard arbitration provisions in franchise agreements governed by California law", and that "there may be no practical way to avoid a finding of procedural unconscionability if the standard set forth by the court in *Nagrampa* is applied".) *See id.* at Exhibit 5 (Faegre & Benson web article as published in *Franchise Times* – March 2007, stating at p. 3 that the decision "is obviously significant to franchisors doing business in California."); and at Exhibit 6 (Raymond T. Nimmer, Contemporary Intellectual Property, Licensing and Information Law posted September 29, 2007, opining that "the Ninth Circuit has embarked on a new path", and excoriating both *Nagrampa* and subsequent Ninth Circuit authority based on it). Thus, the available scholarly, industry and popular press uniformly confirms what is evident from *Nagrampa* itself – that it is a significant new development and departure from prior law in the area of unconscionable arbitration clauses. This clearly belies TKC's assertion (at page 13:16-18) that "even a superficial analysis of *Nagrampa* makes clear that there are no 'new' legal principals. [*sic*]"

In *Buckeye*, the Supreme Court held: "Regardless of whether it is brought in federal or state court, a challenge to the validity of a contract as a whole, and not specifically to the arbitration clause within it, must go to the arbitrator, not the court." *Id.* at 441 (citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 400 (1967)). The *Buckeye* Court also set forth the proposition that unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance. *Id.*

Importantly, the *Buckeye* Court identified two types of challenges to the validity of arbitration agreements: "One type challenges specifically the validity of the agreement to arbitrate....The other challenges the contract as a whole, either on a ground that *directly affects the entire agreement* (e.g., the agreement was

fraudulently induced), or on the ground that the illegality of one of the contract's provisions renders the whole contract invalid." *Id.* at 444 (italics added). The Court ultimately held that the crux of plaintiff's complaint was that the contract as a whole (including its arbitration provision) was rendered invalid by a usurious finance charge. *Id.*

TKC argues that *Nagrampa* simply applied the rule set out in *Prima Paint*, reinforced under the Supreme Court in *Buckeye*. Motion to Dismiss, p. 13. "Specifically, if a party challenges the arbitration provisions in a contract it is a matter for the courts to decide; if, however, the challenge is to the validity of the agreement as a whole it is a matter for the arbitrator." *Id.* Mr. Kayne agrees with TKC that *Nagrampa* acknowledged this general proposition. However, *Nagrampa* put a significant and new gloss on the *Buckeye* holding because, for the first time, it placed the issue of whether an arbitration clause is unconscionable squarely within the hands of the court, *even if substantive state law required an examination of the making of the entire contract as part of that analysis*. *Nagrampa* , 469 F.3d at 1270.[9] The result is that, instead of being required to argue the unconscionability of the TKC "expedited" arbitration procedure to the arbitrator in California (as

[9] The divided *en banc* decision in *Nagrampa* certainly effected a dramatic change from the pre-existing law as articulated by the panel in *Nagrampa I*: In *Nagrampa I*, the panel dismissed plaintiff's evidence as insufficient to demonstrate a procedural unconscionability. The panel held that MailCoups was not required to apprise Nagrampa of the existence of the arbitration clause or the costs associated with arbitration. *Id.* at 1029-30 (citing *Brookwood v. Bank of America*, 45 Cal. App. 4th 1667 (1996)) ("Reasonable diligence requires the reading of a contract before signing it. A party cannot use his own lack of diligence to avoid an arbitration agreement.")). Moreover, the panel stated that Nagrampa was an experienced businessperson who had worked for more than seven years in the direct marketing field. *Id.* at 1030. She had ample opportunity to read the arbitration clause and to consider its implications. *Id.* The panel in *Nagrampa I* also distinguished Nagrampa's situation from one in which an inexperienced consumer was pressured to sign an agreement without being afforded an opportunity to read or comprehend the fine print. Finally, the panel stated: "Nagrampa's failure to read the arbitration clause—or to consult a lawyer about its ramifications—does not excuse her from complying with its terms." *Id.* The *en banc* decision in *Nagrampa* rejected that approach and found the agreement to arbitrate unconscionable as alleged.

Judge Pannell's decision had contemplated), it is now necessary and appropriate for this Court to evaluate that issue.

IV. PLAINTIFFS' CLAIMS UNDER THE CALIFORNIA UNFAIR COMPETITION LAW ARE VIABLE.

At pages 15-20 of its motion, TKC argues that Plaintiff's UCL claims are not viable. The short answer to most or all of TKC's arguments is provided by Judge Jenkins' decision on remand in *Nagrampa v. Mailcoups, Inc.*, 2007 WL 2221028 (N.D. Cal. July 30, 2007) at p. *2-*3:

> Here, the Ninth Circuit's ruling that the arbitration provision as alleged violates California's public policy against unconscionable contracts – which is the law of the case – is tethered to a specific statutory provision under California law. Although unconscionability was originally a judicially-created doctrine under California law, it was codified into California Civil Code Section 1670.5 by the Legislature in 1979. . . . Accordingly, the Court finds it inappropriate to dismiss Plaintiff's sixth claim.

TKC's "collateral estoppel" argument based on the arbitration between TKC and Kayne Art Galleries of Georgia, Inc. ("KAG") fails because Mr. Kayne was not personally bound by that arbitration, as this Court has determined,[10] and because the KAG Arbitration dealt with a different set of agreements (the Dealer Agreement), and not the separate Application for Credit and Personal Guaranty that are at issue here. Similarly, TKC's "judicial estoppel" argument (TKC's memo. at 23-25) grossly mischaracterizes Mr. Kayne's position and this Court's ruling regarding the KAG arbitration. Mr. Kayne argued (and this Court found) that he was not personally a party to the KAG-TKC Dealer Agreements. In making that argument, Mr. Kayne did point out (and the Court agreed) that *one* way of confirming that the Personal Guaranty was not covered by the TKC-KAG Dealer Agreements was to note that the Personal Guaranty had a different arbitration

[10] *See* Order Denying Plaintiff's Motion To Confirm Arbitration (Document 28 in this Court's related case no. C 04-0186 SI, a copy of which is attached as Exhibit 8 to TKC's request for judicial notice) and the Ninth Circuit's decision affirming that order, available at 2007 WL 1544430, 233 Fed.Appx. 684 (9th Cir. 2007).

clause. At the same time, Mr. Kayne made it clear that he had objections to the Personal Guaranty, and the Court in its Order recognized this in its statement that: "*If* Kayne was bound to *any* arbitration, it was the arbitration proceedings under the Credit Application."[11] It is therefore a gross misstatement to assert, as TKC does (in his motion at p. 24, lines 10-11), that "Kayne as previously used the expedited procedures to his advantage." Mr. Kayne has done no such thing and there is no basis for "judicial estoppel" in connection with his claims.

TKC also mischaracterizes Mr. Kayne's claim under the UCL. Mr. Kayne is suing for relief from TKC's arbitration provisions in his own right, not on behalf of KAG. Mr. Kayne was (and in the absence of the requested declaratory and injunctive relief will be) harmed as a result of TKC's failure to make disclosures regarding the Personal Guaranty and the factors surrounding it. Had TKC complied with the franchise laws, Mr. Kayne would have received material information (not limited to information about the arbitration clause itself) that would have significantly reduced the procedural unconscionability surrounding the Personal Guaranty. Further, under the UCL, there is a direct link between TKC's failure to make reasonable disclosures and its misleading statements (under the franchise laws as well as the doctrine of unconscionability) sufficient to give rise to a claim, as recognized by Judge Jenkins in his July, 2007 decision on remand in the *Nagrampa* case, *supra*. In view if the liberal pleading requirements and the standards applicable to Rule 12(b)(6) motions, Mr. Kayne should not be required to allege more at this stage of the proceedings.

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[11] *Id.* (Exhibit 8 to TKC request for judicial notice) at page 4 (Exhibit page 0126), at lines 9-10. (Italics added).

V. MR. KAYNE'S CLAIM THAT TKC'S ARBITRATION CLAUSE IS UNCONSCIONABLE CLEARLY IS VIABLE UNDER *NAGRAMPA*

Because it has a vested interest in enforcing one-sided arbitration clauses in contracts of adhesion that have been drafted by its lawyers and imposed on individual art dealers and owners, TKC apparently is in a state of denial about the meaning of the *Nagrampa* decision. TKC argues (at pages 21-23) that its "no witnesses" arbitration clause is not unconscionable. Contrary to TKC's assertion, Mr. Kayne does allege procedural unconscionability in the FAC, both in the form of failure to comply with franchise disclosure laws (paragraphs 15-29) and in the form of averments involving economic coercion and deception that do not depend on TKC being a franchisor (paragraphs 11-14, 30-32).

Notably, TKC's argument essentially ignores the reasoning of *Nagrampa* and instead tries to distinguish it on the purported basis that "[i]n *Nagrampa* there was no mutuality", whereas here TKC would have the Court believe that the inability to call and cross-examine witnesses to address TKC's accounting invoices submitted in support of a claim of over $1 million is "mutual". This is reminiscent of the observation attributed to Anatole France, that "[t]he law, in its majestic equality, forbids the rich as well as the poor to sleep under bridges. . . ."[12] It is obvious that such a prohibition, which prevents basic due process at the hearing for a substantial amount, operates to the benefit of TKC as purported creditor which can simply submit invoices and await an award in its favor, which (in the form of the Final Award served November 15, 2007) has been forthcoming. If the standards of *Nagrampa* are applied, however, this unconscionable machinery of no-witness "hearings" for million-dollar claims will be stopped by the Court. Further, TKC overlooks that Mr. Kayne, a small business owner from Georgia, is being forced by TKC's clause to defend himself in California and to face claims for attorneys' fees.

[12] *Le Lys Rouge* (The Red Lily), ch. 7 (1894).

Further, TKC argues (at p. 22:16-17) that "using rules promulgated by a nationally recognized third party, the AAA rules simply cannot be deemed to 'shock the conscience'". TKC's argument is wide of the mark, for two reasons noted in the FAC itself, at ¶ 6 and n. 2. First, by their terms, the AAA rules that TKC purports to adopt are designed for small disputes (under $10,000) of a size that the cost of witnesses would likely exceed the amount in controversy. They manifestly were not intended by the AAA for use in million-dollar disputes in which one party (the debtor) has substantial objections to the other side's neat stack of invoices. Second, even the AAA's expedited procedures for small disputes contemplate that witnesses may be requested. By contrast, TKC's custom-made arbitration clause requires that witnesses be called in no circumstance, regardless of the amount in controversy or the needs of the other party to present evidence. TKC's "no witnesses" clause thereby tied the arbitrator's hands and made the outcome a foregone conclusion.

VI. JUDICIAL ECONOMY MILITATES AGAINST DISMISSAL.

Finally, TKC's motion overlooks the fact that the FAC presents the same issues that will inevitably be raised in opposition to TKC's anticipated request for judicial enforcement of the November 15 "Final Award". It makes sense to resolve these issues sooner rather than later, and it makes no sense for TKC to seek dismissal of the FAC for failure to state a claim if the merits of the claims (or elements of those claims) are likely to resurface in the form of defenses to TKC's enforcement of the Final Award.

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VII. CONCLUSION

For the foregoing reasons, plaintiff David Kayne respectfully urges the Court to DENY TKC's motion to dismiss in its entirety.

Dated: November 26, 2007

Respectfully submitted,

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